

VZCZCXRO4689  
PP RUEHAG RUEHDBU  
DE RUEHKB #0582/01 1070734

ZNY CCCCC ZZH  
P 170734Z APR 06  
FM AMEMBASSY BAKU  
TO RUEHC/SECSTATE WASHDC PRIORITY 0158  
INFO RUCNCIS/CIS COLLECTIVE PRIORITY  
RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY  
RUEHBS/USEU BRUSSELS PRIORITY  
RHMFIISS/CDR USEUCOM VAIHINGEN GE PRIORITY  
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RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY  
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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 000582

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E.O. 12958: DECL: 04/04/2016  
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SUBJECT: DAS BRYZA DISCUSSES TRANS-CASPION GAS PIPELINE IN AZERBAIJAN

Classified By: RENO L. HARNISH III; REASONS 1.4 (B,D)

**¶1.** (C) SUMMARY: During an April 3 visit to Azerbaijan, EUR DAS Bryza heard GOAJ interest in a possible "Southern Corridor" of gas pipelines to export gas from Azerbaijan, and perhaps Central Asia through a trans-Caspian gas pipeline (TCP), via Georgia and Turkey to help Europe diversify its gas supplies. Deputy Speaker of Parliament and former Azerbaijani state oil company (SOCAR) executive Valeh Alasgarov supported the idea including TCP, but lamented that such an effort faced obstruction from many European officials, who pursued their own narrow personal interests, including corrupt relationships with Gazprom, rather than their countries' national interests. Azerbaijan-based international oil company representatives believed GOAJ buy-in to expand Shah Deniz gas production and gas transit to Turkey was crucial, and looked to the U.S. for support. Separately, Minister of Energy and Industry Natiq Aliyev told visiting TDA Regional Director Dan Stein March 29 that he supported the TCP concept and believed Turkmenistan might be ready to strike a deal on a TCP. END SUMMARY.

**¶2.** (U) During an April 3 visit to Azerbaijan, EUR DAS Matt Bryza discussed Azerbaijan's possible role in helping Europe diversify its gas supplies. Bryza met with President Aliyev, political opposition leaders, Deputy Speaker of Parliament and former SOCAR executive Valeh Alasgarov, Director of Azerbaijan's State Oil Fund (SOFAZ) Samir Sharifov, and representatives of international oil companies in Azerbaijan. Bryza's meetings with President Aliyev, political opposition leaders, and Samir Sharifov are reported septel. DAS Bryza's visit followed a visit by TDA Regional Director Dan Stein March 28-30 to discuss a feasibility study on trans-Caspian pipeline issues.

Valeh Alasgarov

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**¶3.** (C) DAS Bryza noted that Russia's recent gas cutoff in Ukraine had reenergized European thinking about alternate gas supplies for Europe. He recounted his recent discussions in Rome and Athens in which the Europeans expressed their concern over their growing reliance on Russian gas. Alasgarov agreed that Russia was pushing hard to expand the Black Sea Blue Stream pipeline (under the Black Sea) and strengthen its monopoly power as a supplier to Europe. Alasgarov spoke in favor of a Southern Corridor as perhaps the only way to channel Gazprom away from an effort to stifle competition by acquiring strategic energy assets in Europe, and toward more market-based behavior. Alasgarov warned that

besides Russia and Gazprom, a Southern Corridor faced opposition from officials in France, Italy, Germany, and other European countries, who pursued their own narrow personal interests rather than the national interests of their countries. Many of these personal interests, he said, included corrupt relationships with Gazprom. Alasgarov agreed with Bryza that it would be worthwhile to pursue a TCP to Azerbaijan from Kazakhstan or Turkmenistan, as this would make cheap Central Asian gas less accessible to Gazprom, thereby pressing Gazprom toward reforms required to attract foreign investment to develop domestic Russian gas fields. Alasgarov also believed that Phase II of development of Azerbaijan's Shah Deniz gas field could be expanded to provide an additional 10 to 20 BCM, but that the Italians and Greeks needed to take the first step by offering Azerbaijan a long-term gas sales/purchase contract.

¶4. (C) Turning to the Baku-Tbilisi-Ceyhan (BTC) pipeline and discussions on the Kazakhstan-BTC Inter-governmental Agreement (IGA) aimed at incorporating oil produced in Kazakhstan into BTC, Alasgarov said that all parties now seemed to agree on the relationship of the IFA to the host government agreements (HGA's) governing the project in each country. The IGA would form the legal framework outlining the parties' rights and responsibilities for expanding the BTC project to include cross-Caspian shipping of crude from Kazakhstan. The HGAs would define these rights and responsibilities with specificity in each country to prevent investors from demanding unlimited rights and access to Azerbaijani facilities. As in the case of the original BTC IGA and HGAs (from 1999) the Kazakhstan-BTC IGA would be agreed and initialed; HGAs would then be negotiated; when completed, the IGA would be signed, with the HGAs attached as appendices. Alasgarov argued that Azerbaijan was ready to

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sign the IGA during last May's dedication ceremony for the Azerbaijani portion of BTC, even though it would have preferred to continue negotiations on several key elements. When Kazakhstani President Nazarbayev refused to sign at that time, Azerbaijani President Aliyev decided to negotiate improvements in the IGA from Azerbaijan's perspective. Negotiations seemed to be approaching endgame, according to Alasgarov. The key outstanding issues involved Azerbaijan's desire to ensure that Kazakhstani producers shipped their oil exclusively to Baku, rather than to Iran.

International Oil Company Representatives

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¶5. (SBU) Statoil Azerbaijan President Georg Gundersen noted that the focus of Statoil, which like BP enjoys a 25 percent stake in the Shah Deniz consortium, was on marketing Shah Deniz gas. Shah Deniz Phase II looked promising, with "significant additional production" possible in theory by late 2011 or 2012. To achieve this goal, the commercial foundation for Phase II needed to be finalized by the end of ¶2007. GOAJ buy-in would be essential, he added. EU competition policy could hinder exports to Europe of Kazakhstani gas, and thereby provide a disincentive to expand Phase II production, Gundersen believed. In practice, a joint marketing agreement allowing the Shah Deniz consortium to export its gas to Europe as a single consortium provided the most commercial attractive marketing option. But EU competition regulations prohibited such an arrangement, requiring instead that each company in a consortium market its gas individually. Ironically, Gundersen continued, this EU policy cleared the way for Gazprom, a state monopoly, to sew up much of the European market.

¶6. (SBU) Bryza said he had heard similar worries about EU competition policy from BP, but noted that the European Commission and Council strongly supported development of a Southern Corridor to import Azerbaijani gas - along with Central Asian gas exported via TCP - to Europe. Gundersen noted that there were two camps within the EU Commission.

The energy camp understood the need to diversify supplies, as well as the technical and business realities of getting the gas to market. The anti-trust camp pursued their mission with something "close to religious fervor." He worried that the pressing investment decisions required for Shah Deniz Phase II and a trans-Caspian pipeline would be made much more difficult if the EU required gas to be marketed separately.

¶17. (C) In a separate meeting, BP Azerbaijan President David Woodward and BTC and Shah Deniz Pipeline Director Michael Townsend expressed strong support for development of a Southern Corridor and a TCP for gas exports to Europe. They argued such projects would be commercially attractive to BP and the Shah Deniz consortium, and would help constrain Gazprom's monopolistic tendencies. But they worried such projects were unlikely to succeed absent U.S. support. President Aliyev, Woodward explained, is focused on securing domestically produced gas for consumption in Azerbaijan to shield Azerbaijan against Gazprom's threats to raise gas prices precipitously. Woodward lamented that Aliyev often lacks strategic vision, and seems unaware that Azerbaijan enjoys an opportunity to secure market share for its gas in Greece and Italy, but will lose that chance to Gazprom if he does not move quickly. Woodward and Townsend suggested the U.S. could play a key role in realizing a Southern Corridor by helping Aliyev expand his strategic vision and think beyond Azerbaijan, Georgia, and Turkey as markets for Azerbaijan's gas. Woodward confirmed Alasgarov's claim that if Greece, Italy, and Turkey would put in place necessary infrastructure, the Shah Deniz consortium could more than double Phase II production from 8.6 BCM to 17 or even 20 BCM by 2012. Woodward and Townsend also suggested that the U.S. encourage President Aliyev to open the Azeri-Chirag-Guneshli oil field to exploration for "deep gas" by international companies, which could result in at least as much additional gas production as an expanded Phase II of Shah Deniz. Woodward worried that Aliyev may weighing whether to save this additional gas for the future to provide a strategic reserve and mitigate the approaching problem of managing windfall oil and gas revenues as BTC and the Shah Deniz gas pipeline come on stream later this year. On gas marketing, Woodward said BP had adjusted its strategy, and no longer worried about exporting Shah Deniz gas to Europe as a single consortium. As a result, BP was no longer as concerned as

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was Statoil about EU competition regulations pertaining to gas marketing.

¶18. (C) On BTC, Conoco-Philips representative John Dabbar agreed with Deputy Speaker Alasarov's assessment that negotiations on the BTC-Kazakhstan IGA were approaching endgame. The three key outstanding issues were commercial in nature, namely, Azerbaijan's demands that:

-- BTC enjoy exclusive rights to export all cross-Caspian oil shipments from Kazakhstan;

-- The IGA currently under negotiation pertain only to BTC, thereby requiring Kazakhstani producers to negotiate a new IGA for each additional field from which they may wish to export oil via BTC, which in turn affords the GOAJ repeated opportunities to negotiate more preferential contractual terms; and

-- The governments of Azerbaijan and Kazakhstan form a monopoly shipping company for cross-Caspian tanker shipments.

Dabbar did not seek U.S. intervention on these issues, and believed they would soon be worked out through commercial negotiations.

Minister of Energy

¶19. (C) While unavailable to meet DAS Bryza April 3, former

SOCAR head Natiq Aliyev previously expressed his interest in a possible trans-Caspian gas pipeline during a meeting with TDA Regional Director Dan Stein March 29. Aliyev focused initially on Turkmenistan, and believed President Niyazov was ready to strike a deal after the February visit by the Turkish energy minister to Ashgabat. In Aliyev's view, a Turkmenistan-Azerbaijan gas pipeline was a realistic possibility. Turkmen gas would then be shipped onward to market using roughly 14 billion cubic meters of excess South Caucasus Gas Pipeline (SCP) capacity. Aliyev stressed that such a link could be constructed very soon.

¶10. (C) Shifting focus, Stein recounted past problems with negotiating a TCP with Turkmenbashi. He asked whether a separate pipeline from Kazakhstan to Baku might prove more realistic politically and commercially. Aliyev agreed, noting Kazakhstan's good relations with Russia and the relative lack of Caspian delimitation issues between Russia and Kazakhstan as positive factors. In addition, Aliyev believed that Turkmenistan would have no choice but to join the TCP network through a link to Kazakhstan once an agreement between Azerbaijan and Kazakhstan was struck. Turkmenistan, he argued, had only one safe, secure route for its gas: West.

Comment

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¶11. (C) Azerbaijani interest in Southern Corridor and possible trans-Caspian gas pipeline is high, but further engagement with the GOAJ will be necessary to turn this support into concrete action. International oil companies are likewise interested, but point to regulatory issues in the EU market, and the need for leadership and vision by the GOAJ. With long lead times before any pipeline comes to fruition, cementing the political and commercial basis now for a project of this magnitude is a necessary, and urgent, next step. Clearly, much work remains, but Post welcomes the efforts of the Department and TDA to begin exploring the next stage in energy development on the Caspian.

¶12. (U) DAS Bryza has cleared this message.  
HARNISH